PHILADELPHIA BAR ASSOCIATION

Probate and Trust Law Section Newsletter

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Report of the Chair

By MARY JANE BARRETT

Benjamin Franklin's tercentenary gives us pause as Philadelphians and lawyers to consider the many remarkable traits of one of our most illustrious citizens. Ben was not a lawyer, though his famous quip about the certainty of death and taxes proves he was mindful of our profession's focus. Following his death in 1790, he left his imprint on our body of trust law with the 200 year charitable accumulation trusts he created under his Will for his native and adopted home cities. Through the Philadelphia Fund and the Boston Fund he aspired to encourage the training of artisans, who would in turn become solid citizens who would give back to the community. It is fitting that we challenge ourselves to consider what, if Ben were still among us, we as Philadelphia probate lawyers could do to continue his spirit of public service.

As a printer and postmaster general, Ben might initially be piqued that the Probate and Trust Section Newsletter, now supplemented by the Probate Section E-Alert for interim bulletins, is no longer printed and mailed, but disseminated via the listserve and posted on the bar association's website (www.philadelphiabar.org). But as an inventor, Ben would be thrilled with the technology and would probably have his own blog to tell of Poor Richard's adventures.

Without stretching the point too far, it can be said with assurance that as a self-educated small businessman, who promoted or built institutions of higher learning, libraries, hospitals, fire departments, and insurance companies and engaged in scientific inventions, politics, lawmaking and international diplomacy, he would have made the acquaintance of lawyers on all of the Section's diverse committees: Closely Held Businesses (Karin Kinney, Chair); Education (Judy Stein, Acting Chair); Elder Law (Keelin Barry, Chair); Legislative Committee (Rob Friedman, Chair); Orphans' Court Litigation and Dispute Resolution (Larry Norford, Chair); Probate and Trust Section Newsletter (Bob Louis, Chair), Public Service Committee (Howard Soloman, Chair); Rules and Practice (Nina Stryker, Chair); Taxation (Jill Fowler, Chair), and the Register of Wills Ad Hoc committee (Gene Gillin, Point Person-in-Chief), which is actively consulting with the Register of Wills office (where Ben's Will was probated) as it embraces computerization and electronic filing in the near future.

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Report of the Chair, continued

Yet, despite his fascination with the developments of the past 300 years, Ben might be somewhat disapproving of the culture of the legal profession he would find today -- driven beyond sensibility by the pursuit of the billable hour and the bottom line. Ben himself worked hard to become prosperous and escape the poverty of his early years, but he did not aspire to excessive wealth or great leisure. Rather, he retired at age 41 to live comfortably, but with time to study, invent, philosophize and serve his fellow man in various capacities for the second half of his life. Many of our Section members are generous contributors of their time and effort to Bar Association projects, pro bono matters, charitable and civic committees, and religious and community endeavors. Yet there are some of us who are not yet "plugged in," whose energy and talents are needed to take pro bono cases and court appointments and get involved with the work of the Section's committees. Ben's admonition to serve is singular: "If you would not be forgotten, as soon as you are dead and rotten, either write things worth reading, or do things worth the writing." To his kindred Philadelphians three centuries removed, Ben would likely urge us to take the time to do things worth the writing as well as the time to go fly a kite.

The Basics: The Rule in Shelley's Case

By ROBERT H. LOUIS, ESQUIRE
SAUL EWING, LLP

It's been suggested that, in addition to articles on rolling GRATs, sales to defective grantor trusts, and arcane forms of hedge funds, this publication should occasionally get back to basics, and what could be more basic than The Rule in Shelley's Case?

The Rule in Shelley's Case (formally *Wolfe v. Shelley*, 1 Co. Rep. 93b, 76 Eng. Rep. 206 (C.P. 1581)) was a rule of interpretation of words of transfer of property. Fortunately, the defendant's counsel in the case was also the reporter, Edward Coke, and the statement of the rule comes from his argument, not the court's decision. The Rule itself predates the case by many years, having been referred to as early as the decision in *Abel's Case,* from the year 1324, or perhaps the decision in the *Provost of Beverley's Case*, in 1366.

Shelley's case arose from a transfer made by Sir William Shelley, an English judge himself, of an estate he had acquired on the dissolution of a monastery. The case was decided by the Lord Chancellor, Sir Thomas Bromley, in 1581. It revolved around this question: in a transfer of property to one person for life, with the remainder to go to that person's heirs, what does that person own? Coke reported his argument in the case, as follows:

> It is a rule of law, when the ancestor by any gift or conveyance takes an estate of freehold, and in the same gift or conveyance an estate is limited either mediately or immediately to his heirs in fee or in tail, that always in such cases "the heirs" are words of limitation of the estate and not words of purchase.

In their casebook *Cases and Text on Property*, Casner and Leach stated the rule as follows: "If an instrument creates a freehold in A and purports to create a remainder in A's heirs (or the heirs of A's body) and the estates are both legal or both equitable, the remainder becomes a fee simple (or fee tail) in A. That is, A receives a fee simple interest, by operation of the Rule and the doctrine of merger. (The Rule gives the holder of the life estate the remainder, and the doctrine of merger merges the two interests into a fee simple.)

What was the reason for this transfer technique? Some scholars have suggested that it was an attempt to prevent the transferee of property from reselling it, by limiting his rights in rights in the property. Others view it as an effort to avoid a tax (called a "relief") and other feudal rights that were imposed when property passed by descent. By framing the grant of property as a life estate followed by a remainder to the grantee's heirs, the heirs would not receive the property as an inheritance, but as remaindermen, and thereby avoid the tax and other obligations (more proof that all human activity is governed by the desire to avoid taxes). The holding in *Shelley's Case* prevented that particular technique from avoiding

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Medicare D: Prescription Drug Plan Evaluation Basics

By SUSAN H. KAVANAGH

By 2015, one in every five dollars spent in the United States will go towards medical costs. A couple retiring in 2005 at age 65 will spend an estimated $200,000 for uncovered medical expenses. The introduction in January, 2006 of the Medicare D prescription drug program will help to offset such retiree expenses while protecting seniors' assets with basic and catastrophic prescription drug coverage.

Who is eligible:
Anyone who is covered by Medicare A or B.

Who should not enroll:

- Persons covered under an employer-sponsored health insurance plan that declares its plan offers "creditable coverage." Such plans may require the member to disenroll from their retiree-sponsored plan if the retiree enrolls in a Medicare D plan. This can have far-reaching implications, i.e., loss of employer-subsidized health insurance, dental and/or vision care benefits, etc.
- Persons covered under Veteran's Administration, TRICARE, Pace or Pace Net plans

Who should revisit their current Medicare Medical Plans:

- Persons covered under Medicare HMO plans
- Persons covered under Medicare Advantage plans
- Persons covered under Medigap plans (H, I, J)

Note: enrollment in a separate Medicare D plan may force disenrollment from the above plans leaving the member with only Medicare A and B coverage. The member should contact the plan administrator before making any changes. These plans may or may not offer comparable prescription drug benefits to the independent Medicare D carriers.

Standard Medicare D Coverage:

- $250 upfront deductible
- Member pays 25% with Medicare paying 75% of the next $2,000 in drug costs (member responsible for $500 out-of-pocket)
- After paying $2,250 of drug costs, there is no coverage (the coverage gap) until the member pays another $2,850 or 100% of drug expenses.
- After the member pays $3,600 out-of-pocket for prescription drugs in a year ($250 deductible + $500 in coinsurance + $2,850 from the coverage gap), Medicare pays for "catastrophic coverage." Catastrophic coverage begins after all of the member's eligible Part D out-of-pocket drug expenses in addition to what Medicare pays total $5,100 (member's costs of $3,600 + Medicare's costs of $1,500). At this point the member pays $2 for generic and $5 for brand-name drugs or 5% of the costs, whichever is greater. There are no maximums or limits for the remainder of the calendar year.

Evaluating Plans:

- If the client is using minimal or no prescription drugs and is healthy, it may make sense to delay enrollment in a Medicare D plan and incur the 1% per month late enrollment penalty. This would save the

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Shelley's Case, continued

the obligation, and merely led to the development of other techniques to accomplish the same goal.

The Rule in Shelley's Case survived long after the perceived need for the Rule disappeared, as a result of the abolition of the feudal duties, and in any event it wasn't difficult for lawyers to find ways to circumvent the rule. A court in North Carolina, in *Stamper v. Stamper*, 121 N.C. 251, 28 S.E. 20 (1897), called it "the Don Quixote of the law, which like the last knight errant of chivalry, has long survived every cause that gave it birth and now wanders aimlessly through the reports, still vigorous, but equally useless and dangerous." In Pennsylvania, the Rule was abolished by legislation in 1935, 1947, and again in 1972 (See 20 Pa.C.S.A. §§2517 and 6117).

Sources: In addition to the Casner and Leach casebook, an article in the Autumn 2003 issue of *The Green Bag* by John V. Orth, *"The Mystery of the Rule in Shelley's Case."*

Medicare D, continued

cost of monthly premiums until such time as prescription drug usage justifies enrollment in a Medicare D plan. However, after the May 15, 2005 initial open enrollment deadline passes, the ability to enroll in a plan will be restricted to Medicare's annual open enrollment period and the member will be assessed a 1% per month premium penalty (this date also marks the end of the Medicare-approved drug discount program). Alternatively, the client can enroll in a low premium plan (some cost less than $10 per month) if they are concerned about the annual open enrollment restriction and/or late enrollment penalty.

• Compare the client's list of prescription medications (start with most expensive) against the formularies of Medicare-approved insurers in their geographic area (also check to be sure the client's neighborhood pharmacy is in the insurer's network). Note: some drugs are not approved by Medicare for coverage and the insurer may or may not offer a discounted price for such drugs.

• When you have a match for the pharmacy and formulary, then look at the plan details, as follows:

1. Monthly premium cost.

2. Is the annual upfront deductible waived?

3. Is the member responsible for paying coinsurance for each prescription or flat co-payments? If coinsurance, how deep are the discounts for each drug?

4. Are there any per drug caps on the member's out-of-pocket coinsurance exposure?

5. Are co-payments different for generic, preferred and non-preferred formulary drugs? If so, calculate cost of each.

6. Will the client find it difficult to manage a co-insurance-type plan vs. a flat co-payment plan?

7. How does the insurer perform from a customer service perspective, e.g. wait time on hold, ease of navigation of telephone system, expertise and patience of customer service representative, etc?

• Calculate the client's current annual out-of-pocket cost and compare it to what each plan's estimated out-of-pocket cost will be, including the annual premium cost of each. This comparison will show the net change in cost for the client. You should note that plans must offer the minimum or standard benefits mandated by Medicare but can offer additional coverage to attract enrollees. For example, some insurers are offering generic drug coverage and/or discounts to assist the member with costs once they hit the "coverage gap" (see Standard Medicare D Coverage above).

Overall, the Medicare D program will offer needed relief from the expense incurred by seniors for their prescription drugs. Manageable costs will ensure greater compliance with medication regimens and help seniors stay healthier longer. This is good for seniors, their caretakers and the healthcare system in the United States.

Where to Find Medicare Advice:

• www.medicare.gov or 1-800-Medicare

• Pennsylvania Health Law Project 1-800-274-3258 or www.phlp.org

• Center for Advocacy for the Rights and Interests of the Elderly (CARIE) 215-545-5728 or www.carie.org

• Community Legal Services Elderly Law Project (for low income Philadelphia residents) 215-227-2400

• APPRISE, a free health insurance counseling program to help Pennsylvanians with Medicare 1-800-783-7067

Please note: this is a general description of the Medicare D plan and is not meant to represent all of the benefits or options available to the consumer. For comprehensive details regarding the Medicare D program, you should refer to the resources listed above (see Where to Find Medicare Advice).

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Major Changes in Pennsylvania Medicaid for Long-term Care

By ROBERT C. GERHARD III, ESQUIRE
CELA

Medicaid planning is a fast-moving practice area within the field of elder law. The recent cutbacks embodied in Act 42 of 2005 ("Act 42") and the Deficit Reduction Act of 2005 ("DRA") illustrate how dramatically and quickly Medicaid law can change. Within the span of just seven months, the methodology for calculating the protected share of resources for a community spouse in Pennsylvania has totally changed, the eligibility rules for Medicaid in the home and community-based setting were completely overhauled, and a number of Medicaid planning techniques such as "half-a-loaf gifting" were curtailed or entirely eliminated.

In the face of this turmoil, some Medicaid planning attorneys have shifted their focus to other related practice areas, such as preparing special needs trusts or selling annuities and long-term care insurance. Other practitioners hoping to continue are concerned about what advice they can give as the Medicaid planning options have been decimated. Significant planning opportunities remain even after this major legislative overhaul and understanding these technical rules is more important than ever. The balance of this article will highlight the major changes of Act 42 and the DRA.

Act 42 of 2005. Faced with Medicaid costs that were outpacing state revenues, Pennsylvania legislators passed Act 42 of 2005 and Governor Rendell signed it into law on July 7, 2005, hereinafter "Act 42." Pennsylvania's Public Welfare Code was amended to include several new sections designed to reduce long-term care expenditures by tightening certain eligibility requirements See 62 P.S. §§441.3 - 441.8.

Major changes of Act 42 include:

1. Elimination of resource-first rule. The resource-first rule, embodied in the so-called *"Hurly"* appeal," was eliminated by Act 42. A "modified income-first rule" was created by Act 42 in order to address the risk of spousal impoverishment that would otherwise be presented by implementation of a straight "income-first rule." Under the new approach, and effective for applications filed after October 1, 2005, a guaranteed lifetime annuity meeting certain criteria is purchased to help protect the community spouse from impoverishment. The annuity makes payments for the community spouse to the extent income would be insufficient to meet his or her monthly living costs after the death of the institutionalized spouse. Under the Act 42 annuity rules, the Commonwealth must be named as remainder beneficiary. If the community spouse dies before the payments under the term certain of the annuity end, the state is reimbursed with whatever remaining payments exist under the contract, not to exceed the amount of Medicaid benefits paid. The continued viability of this approach is in doubt given the enactment of the DRA and its mandate that states follow a strict "income-first rule." 62 P.S. §441.7.

2. Imposition of partial months of ineligibility. The calculation of the penalty period for asset transfers by a Medicaid applicant was altered to impose partial months of ineligibility, effective August 22, 2005. The pre-Act 42 methodology ignored partial months of ineligibility. The current monthly penalty divisor is $6,062.35/month, or $199.31/day. 62 P.S. §441.5.

3. Life estate deeds with retained powers. Medicaid applicants who created life estate deeds and retained the power to revoke, amend, or redesignate the remainderman must exercise those rights as directed by the Department of Public Welfare as a condition of receiving public benefits. 62 P.S. §441.6(a).

4. Annuities presumed available. Provisions of an annuity owned by a Medicaid applicant or spouse of a Medicaid applicant that purport to limit the right of the owner to sell, transfer or assign the right to receive payments, or restrict the right to change the designated beneficiary are void. Annuities are presumed to be marketable without undue hardship. 62 P.S. §441.6(a), 62 P.S. §441.6(b).

5. Medicaid qualified annuities. A commercial, irrevocable, guaranteed annu-

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ity which pays out in equal monthly installments will not be considered "available" for purposes of qualifying for Medicaid if the annuity names the Department of Public Welfare as the residuary beneficiary, not to exceed the amount of Medical assistance expended on the individual during his or her lifetime. 62 P.S. §441.6(d).

6. Home and community-based long-term care eligibility. Applicants for home and community-based services, such as the PDA 60+ Waiver Program, must now meet all medical and financial eligibility requirements that would apply if the individual were applying for long-term care nursing facility benefits. This dramatically impacts eligibility for such care in spousal cases. The Department of Public Welfare no longer limits its review of resources to the applicant, but also examines the resources of the healthy, care-giving spouse. 62 P.S. § 441.8 (1 - 3).

Deficit Reduction Act of 2005. The Deficit Reduction Act of 2005, hereinafter "DRA," was signed into law by President Bush on February 8, 2006. (See, *Public Law No. 109-171; Title VI, Subtitle A - Medicaid, Chapter 2 - Long Term Care Under Medicaid, Subchapter A- Reform of Asset Transfer Rules*, §§6011 - 6021 and *Subchapter B-* §6022 *Expansion of State Long-term Care Partnership Program.*) The full text of the DRA can be found in the "Public Laws" section of the Library of Congress website, http://thomas.loc.gov/ .

The Medicaid reform provisions of the DRA are intended to slow the growth of Medicaid spending as the nursing home population increases in coming years, especially as baby-boomers eventually require long-term care. The DRA reforms take aim at many last-minute Medicaid planning techniques, particularly the divestment of assets and the strategy known as "half-a-loaf gifting." Overall, the rules imposed by the DRA strongly encourage the purchase of long-term care insurance as the preferred way to finance long-term care.

The major DRA changes include:

1. Extension of the look-back. The look-back period is extended from three years to five years for outright transfers occurring after the effective date of the act. DRA §6011(a).

2. Change in "start date" of ineligibility period. Once implemented, the ineligibility period caused by gifting commences on the date when the applicant would otherwise be eligible but for the penalty period caused by the gift, no longer on the first day of the month in which the gift was made. Gifts can cause problems up to five years later after the fact. Gifts made prior to the enactment of the DRA are grandfathered in under the old rules. DRA §6011(b).

3. Annuity rules. The purchase of certain annuities are treated as transfers for less than fair market value unless the state is named as remainder beneficiary behind the community spouse, minor child, or disabled child, for "at least" the amount of medical assistance paid. DRA §6012.

4. Mandated "income-first rule." When determining the increased share of resources for a low-income community spouse, a strict "income-first rule" must be followed, rather than a "resource-first-rule" or the "modified income-first rule" created under Act 42. The community spouse must first look to the institutionalized spouse's income before additional assets can be protected. Most Pennsylvania elder law attorneys would agree that this particular provision will lead to an increased number of cases where spouses are impoverished and unable to meet expenses after the death of the institutionalized spouse. DRA §6013.

5. Ineligibility for those with substantial home equity. The applicant's residence is no longer automatically exempt. Applicants with home equity exceeding the state-determined maximum will be denied benefits. Federal law mandates that states set the home equity limit between $500,000 and $750,000. Exceptions apply where a spouse, minor child, or disabled child lives in the home. Applications for hardship exceptions to this new requirement will also be considered. Policy makers seek to encourage the use of reverse mortgages to tap home equity. DRA §6014.

6. Expansion of state long-term care partnership program. The DRA grants states the authority to expand the Long-term Care Partnership Program, a program designed to encourage state residents to

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OPINION SUMMARY

By PATRICK NAESSENS, ESQUIRE
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Trust Under the Will of Charles S. Child, Deceased, O.C. No. 3055 ST of 1929 (November 7, 2005 Herron J.)

In *Trust Under Will of Charles S. Child, Deceased*, Philadelphia County O. C. No. 3055 ST of 1929 (November 7, 2005 Herron J.) the court was presented with the issue of which generational level of the Testator's sisters should serve as head of the stirpes for determining the scheme of distribution of the trust's principal upon termination.

The Will provides that the trust would continue "until the death of the survivor of my two sisters, <u>Mary B. Child and Caroline T. Howland</u>, and my two nephews, <u>Llewellyn Howland and Edward Morris Howland</u>, and such of the children of my said nephews as shall be living at the time of my death…." Testator's nephew, Llewellyn, had 3 children and his other nephew, Edward, had 2 children. All five grand nieces and nephews were living at Testator's death, the last one dying during 2004. The Will continues that:

> "[U]pon termination of the Trust as aforesaid to ...pay over the principal of my residuary estate unto such of the children and issue of deceased children of my said nephews, Llewellyn Howland and Edward Morris Howland, as may be living at that time equally, absolutely, per stirpes, ..."

At audit, the trustee proposed distributing the principal equally among all grand nieces and nephews per capita, which results in Llewellyn's issue receiving 60% of the principal while Edward's issue would receive 40% of the principal. Objectants argued that the Testator intended his nephews to be at the head of the stirpes, which would result in a 50/50 division of the principal, to be distributed per stirpes among their children and issue of deceased children, the same as had been done with income throughout the Trust's administration.

The court held that the dispositive language and scheme in the Will concerning principal and income supported the Objectants' position that the Testator intended his nephews to be at the head of two stirpes for determining the distribution of principal upon termination of the Trust. In so holding, the court found it significant that:

> 1. The dispositive language in the Will for principal, just like for income, focuses on the two specifically named and underlined nephews;
>
> 2. The recipients of the principal are identified solely in terms of their relationship to the nephews rather than in terms of their relationship to the Testator; and
>
> 3. The language in the Will concerning termination of the trust underscores the nephews' role as head of the stirpes where it describes the nephews' generation as a discrete, clearly defined and complete class for the purpose of determining subsequent distributions while the grand nieces and nephews were not so defined.

Additionally, the court focused on the fact that all the remaindermen were in agreement that during administration income had been properly distributed at the nephews' generation, per stirpes. Citing *Wanamaker Estate*, 399 Pa 274 (1960) and *In re: Trust Under Will of Barclay McFadden*, 705 A.2d 930 (Pa. Super. 1998), the court determined that absent clear language in the dispositive provisions for principal and

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purchase long-term care insurance. Individuals who purchase long-term care insurance policies that meet specific requirements can qualify for Medicaid without having to spend-down as much as would be the case in the absence of a qualifying long-term care policy. DRA §6021.

Robert C. Gerhard, III Esquire limits his practice to elder law and Medicaid planning with the Montgomery County law firm of Gerhard & Gerhard. He is author of the law treatise, *Pennsylvania Medicaid, Long-Term Care*, published by the George T. Bisel Company. He can be reached for questions or comments at rgerhard@paelderlaw.net.

JOIN A COMMITTEE

The Section's Committees depend on the steady flow of people, energy and ideas. Join one! Fill in the form below and send it to the Section Chair:

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	Third:

Opinion Summary, continued

income indicating a contrary intent, principal should be distributed in the same manner as income had been distributed during the trust administration, which was down two equal lines of descent headed by each nephew, per stirpes.

NEWSLETTER ARTICLES

Would you like to see something in future issues of the Probate and Trust Law Section Newsletter? Then, why don't you write it? If you are interested, please contact the Editor:

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----------- *Probate Section E-Alert* -----------

This is the first of what we hope will be regular e-alerts to members of the Section, reporting on current developments and offering practical advice. Our Section Chair, Mary Jane Barrett, suggested this format and has compiled most of the initial content. For future issues, we plan to report on the work of committees within the Section and to circulate other information that will be of value in our practices. We also hope that members of the Section will offer items of interest, which can be sent to me at rlouis@saul.com. The various e-alerts will be collected in our newsletters. --Bob Louis

1. Philadelphia Recorder of Deeds - Fee Increase - Beginning September 12, 2005, a new fee for the Philadelphia Housing Trust was imposed, in the amount of $72. The announcement stated that 65% of the funds collected in the first year will be used to support the building of new homes and apartments, 30% to preserve existing homes, and 5% to prevent homelessness. The press release is available at www.pacdc.org/TrustFund/. The fee schedule is found at www.phila.gov/records/pdfs/82-Misc.-132.pdf.

2. Computation of Account Filing Fees in Philadelphia - How to get it right - Following various reports of inconsistency in the manner in which filing fees for accounts are computed in Philadelphia, a question was posed to Caren Martin, Esquire, of the office of the Clerk of the Orphans' Court, who advised that fees are based on the sum of the principal receipts, gains on principal conversions, and income receipts.

3. Special Needs Trusts - Relief for disabled but not incapacitated adults - Attorneys who create first party or OBRA '93 or pay-back special needs trusts have been frustrated by the omission in the federal statute, which states that such a trust must be settled by a "parent, grandparent, guardian or the Court" when the funds belong to a physically disabled but competent adult who lacks a living parent or grandparent. In the past, the local courts have been reluctant to act as the "settlor" of the trust, despite the apparent Congressional authority, based on the absence of such authority in the Probate, Estates and Fiduciaries Code. Recently, judges from both Montgomery and Philadelphia Counties have agreed to act as the settlor in such matters, in order to avoid an injustice, and apparently in recognition of the drafting error in the statute that omitted the individual from the category of individuals from the category of persons entitled to create the trust.

4. Rule of Professional Conduct 1.15 - Proposed changes threaten attorneys/fiduciaries - There is a movement afoot in Pennsylvania to change Rule 1.15, so that it applies not only to funds that an attorney holds in escrow for a client, but also to estate and trust funds an attorney holds solely in his or her capacity as a fiduciary (executor, trustee, guardian, etc.). The Office of Disciplinary Counsel ("ODC") reports that the proposed changes are necessary to discipline thieving and incompetent lawyer-fiduciaries. The problem that has arisen is that the ODC's proposals conflict directly with substantive fiduciary law. For example, the effect of the first draft would have required an attorney-fiduciary to hold all estate or trust funds in an interest-bearing account in a Pennsylvania institution pursuant to an agreement between the institution and the Pennsylvania Supreme Court to report overdrafts to the authorities - clearly not a rule with which an attorney-fiduciary could comply in most cases. The second draft would allow expanded investment options, but would retain the requirement of a Pennsylvania depository and mandatory overdraft reporting, effectively limiting a lawyer-fiduciary's investment options (as most financial institutions will not want to modify complicated trust department or wealth management systems to comply). The new draft also imposes record-keeping, notice and accounting requirements that are less complex but that also raise practical concerns.

5. The Red Book component of the Philadelphia Estate Practitioner Handbook is now available on-line at www.peph.org.

6. The Section is a co-sponsor, with the Alternative Dispute Committee and the Family Law Section, of a program titled "Addressing Loss, Retribution and Closure in Mediation", presented by Craig Lichtman, M.D., M.B.A. The program will be held on April 6 beginning at 12:15 P.M. at the Philadelphia Bar Association offices.

ETHICS COLUMN

By PAUL C. HEINTZ, ESQUIRE
OBERMAYER REBMANN MAXWELL AND HIPPEL, LLP

Do the Pennsylvania Rules of Professional Conduct prohibit a lawyer from engaging in a consensual sexual relationship with a client?

Pennsylvania has not joined the minority of States, including New York, that have adopted rules specifically prohibiting attorney-client sexual relations. However, the Pennsylvania Bar Association's "Legal Ethics and Professional Responsibility Committee", in its Formal Opinion 97-100, has opined that: "During the course of the lawyer-client relationship, a lawyer shall not require or demand that a client or a representative of a client engage in sexual contact with the lawyer or attempt to coerce a client or a representative of a client into engaging in sexual conduct with the lawyer."

The Committee was moved to act because the Pennsylvania Disciplinary Board had expressed concern about an increasing number of complaints of such episodes.

Most likely, however, actual coercion does not give rise to the majority of such relationships. Probably, and this is at least as troubling, such relationships arise when the client is in an emotionally vulnerable state. While such vulnerability is most common in the domestic relations field, it can also exist in the trust and estates field, particularly when the client has just experienced the death of a spouse or close family member.

The Committee's comprehensive opinion cites two points of special importance to the trust and estates lawyer. The first is that a lawyer has a fiduciary relationship with the client. Remembering this fiduciary relationship when settling an estate is important because the lawyer usually is in a position superior to the client who, in the midst of the estate administration, could be vulnerable to exploitation. Second, the phenomenon of "transference" can be as applicable in the lawyer-client relationship as it is in the therapy professions. Transference occurs when the client transfers feelings to a professional which are more appropriately directed toward another person of importance in the client's life. According to the experts, transference is an "unconscious phenomenon in which the feelings, attitudes and wishes originally linked with important figures in one's early life are projected onto others who have come to represent them in current life." Of course, not every lawyer-client relationship will involve transference issues. But, if it exists, the lawyer has neither the training to spot it nor sufficient awareness of the serious harm that may occur to the client if the relationship is abused. The Committee notes that the trauma a client can experience when the awareness of the exploitation becomes conscious may be long-term and highly damaging. Of course, the trauma can also result in the client's complaint to the Disciplinary Board and action against the lawyer.

Although there are no "bright-line rules" applicable to such lawyer-client relationships, the Committee urges lawyers to bear in mind the threats to professionalism, including over-reaching a client, conflicts of interest and impaired judgment, that often accompany personal and professional relationships. The Committee also warns that even without a demand or coercion, a lawyer's sexual contact with a client may be viewed as a violation of the Rules of Professional Conduct. As the Committee noted, such contact can implicate a series of Rules of Professional Conduct, including, but not limited to the duty to provide competent representation (Rule 1.1), the duty to avoid conducting a representation that may be materially limited by the lawyer's own interests (Rule 1.7), the duty to avoid using confidential client information to the client's disadvantage (Rules 1.6 and 1.8), the duty to maintain, so far as reasonably possible, a normal lawyer-client relationship with a client under a mental or emotional disability (Rule 1.14) and the duty to exercise independent professional judgment (Rule 2.1).

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

Send your questions and ideas to:

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TAX UPDATE

By JOAN AGRAN, ESQUIRE
MCCAUSLAND, KEEN & BUCKMAN

I. COURT DECISIONS

Estate Cannot Discount IRA for Taxes or Lack of Marketability

In *Estate of Doris F. Kahn, 125 TC No. 11 (2005)*, decedent at his death owned two IRAs; both IRA trust agreements provided that the interests in the IRAs themselves were not transferable; however, both IRAs allowed the underlying marketable securities to be sold. On the estate tax return, the estate reduced the net asset value of the IRAs 21% and 22.5%, respectively, to reflect the anticipated income tax liability from the distribution of the IRAs to the beneficiaries. The Service issued a notice of deficiency, determining among other items, that the estate had underreported the value of the IRAs.

The estate took the position that under Code Sec. 2031 the fair market value of the IRAs should be reduced to reflect (i) the income tax liability associated with them, and (ii) the fact that because the IRAs themselves are not transferable, they are unmarketable. The estate contended that the only way the owner of the IRAs could create an asset that a willing seller could sell and a willing buyer could buy would be to distribute the underlying assets in the IRAs and to pay the income tax liability resulting from the distribution, thereby making the income tax to be paid by the beneficiary a "cost" necessary to "render the assets marketable," which must be taken into account in the valuation of the IRAs.

In support of its argument, the estate cited cases from the different areas of estate valuation that have allowed a reduction in value of the assets, and argued that the IRAs should be discounted because they are similar in nature to (i) to unassignable lottery payments, (ii) stock in a closely held corporation, (iii) stock that is subject to resale restrictions, (iv) contaminated land, and (v) land that needs to be rezoned to reflect the highest and best use.

The Tax Court rejected the estate's arguments, stating that the various lines of cases don't apply to IRAs because the tax burden associated with distributing the assets in the IRAs will never be transferred to a hypothetical buyer. The Tax Court also noted that decedent's beneficiaries will be allowed a deduction under Code Sec. 691(c) in the amount of Federal estate tax paid on the items of IRD included in the distributions to them from the IRA.

Charitable Deduction Permitted on Termination of Nonqualifying Split-Interest Trust

In *Jackson Est. v. U.S., No. 2:04CV34 (N.D. W. Va. 11/23/05)*, during her lifetime, decedent created a revocable trust from which she received income and principal until her death, at which time the trust became irrevocable. At decedent's death, a specified sum was to be distributed to decedent's nephew and three nieces. The balance was to be retained in trust, with the income divided equally among the nephew and nieces. Upon the death of each niece or nephew, a specified church was to receive 1/4 of the trust principal.

After decedent's death, due to a concern about potential conflicts of interest among decedent's nephew and nieces, the parties signed an agreement to terminate the trust. The trustees distributed a portion of the trust assets to decedent's nephew and nieces, based on their life expectancies under the Internal Revenue Service actuarial tables. The remainder of the trust was distributed to the specified church. The estate claimed a charitable deduction for the amount distributed to the church, which the Service denied, assessing additional taxes and interest. The estate paid the additional amounts and filed an appeal. After the Service denied the estate's appeal, the estate filed suit.

On the basis of these facts, the District Court held that because the trustees terminated the trust in good faith due to conflicts of interest which threatened the trustees' ability to impartially administer the trust, the Service must refund the additional taxes and interest to decedent's estate. The court noted that (i) the church received an outright distribution of assets under the termination agreement; (ii) decedent's nephew and nieces had no interest in those assets at the time of distribution; (iii) the estate deducted an amount equal to the amount received by the church; and (iv) no evidence suggested that the parties executed the termination agreement to circumvent Code Sec. 2055(e).

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Residuary Gift to Spouse in Self-Drafted Will Qualifies for Marital Deduction

In *Sowder v. U.S., 96 AFTR 2d 2005-5598 (E.D. Wash. 11/10/05)*, decedent, who had prepared his own Will, was survived by his wife and three children. Following bequests of his tools to his sons and $200,000 to each of his children, he gave the residue of his estate to his wife, if she survived him. If she did not survive him *or* if she died before the estate was distributed to her, he gave the residue of his estate to his issue. Decedent's handwritten notes found with his will did not include the reference to wife's survivorship until distribution of the estate. Decedent named his wife as his executrix, with full power over the administration of his estate.

Evidence indicated that decedent understood the concept of deferring taxes until the death of the second spouse, that decedent had read an article regarding the marital deduction, and that decedent did not want to pay more tax than necessary. In addition, based on her discussions with the decedent, his wife understood that estate taxes would be due only at the second death.

Decedent's estate tax return indicated that no tax was due, based in part on the marital deduction. The Service audited the return and assessed deficiencies, which the estate paid and then filed a claim for refund. The Service denied the refund claim and the estate filed suit. In 2002, the district court granted the estate's motion for summary judgment, finding that decedent intended a marital deduction gift. The Ninth Circuit Court of Appeals reversed the summary judgment to the extent it denied the Service's right to conduct additional discovery and remanded to the district court.

On remand, the district court held that the estate had demonstrated that decedent's gift to his wife qualified for the marital deduction. The court noted that, under applicable state law, a marital deduction gift is defined as a gift intended to qualify for the marital deduction as indicated by a preponderance of the evidence, including the governing instrument and extrinsic evidence, whether or not the governing instrument is ambiguous. State law in this case also specified that the governing instrument will be construed to comply with the Code Sec. 2056 marital deduction provisions in every respect if it is determined that the testator intended a marital deduction gift.

Decedent's Promissory Note to Corporation Not Deductible as a Claim Against Estate

In *Hughes Est. v. Comr., T.C. Memo 2005-296 (12/27/05)*, decedent, who died in 1999, and her husband who had died in 1996, had during their lives established a trust, a property business, and other entities to hold most of their assets. The trust was to benefit decedent and, after decedent's death, their children, grandchildren, and charity. After husband's death, the executor of his estate also became trustee of the trust and manager of the other entities. The executor also became decedent's agent under a durable power of attorney.

During his life, husband had founded an automobile sales and leasing corporation which financed its car purchases with loans from husband and the family entities. When husband died in 1996, the trust owned all the corporate stock. Executor became the corporation's sole officer and director. In 1997, to ensure one of decedent and husband's sons, who was a corporate salesman, had a place to work, the executor, as decedent's agent and as the corporation's president, signed a stock subscription agreement under which decedent agreed to pay the corporation $400,000 on demand and the corporation issued decedent an additional 4,000 shares of the corporate stock. The terms were not negotiated and the corporation's bookkeeper and certified public accountant did not know about and did not identify the stock subscription agreement or note it on the corporation's 1997 and 1998 financial statements or tax returns. After decedent's death, the executor, as trustee of the trust, paid the $400,000 to the corporation. The corporation's financial statements showed net losses and a negative net worth from 1994 through 1999 and then ceased operations in 2000.

Decedent's estate tax return included in the gross estate $150,000 of principal the corporation owed on notes to the business property and the trust, but not $21,782 of interest owed on those notes as of decedent's death. The return deducted the $400,000 paid on the note from decedent to the corporation as a claim against decedent's estate. The Service denied the $400,000 deduction and sought to include the $21,782 of interest.

The Tax Court held on the basis of these facts that the $400,000 promissory note from decedent to the corporation could not be deducted as a claim against decedent's estate under Code Sec. 2053(a)(3), because the note was not contracted bona fide for full and adequate consideration.

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Under Code Sec. 2053(c)(1)(A), claims against an estate that are enforceable under state law may be deducted under Code Sec. 2053 only if the liability was contracted bona fide and for full and adequate consideration. The court found this not to be the case, stating that this transaction was subject to enhanced scrutiny because executor, as decedent's agent and the corporation's sole officer and director, was on both sides of the transaction. The court found in this case that the transaction was a substitute for a testamentary disposition and was not bona fide because: (i) the parties did not negotiate terms at arm's length; (ii) the parties did not appraise the corporation's value; (iii) the corporation had net losses and negative net worth both before and after the transaction; (iv) the corporation's 1997 and 1998 financial statements and tax returns did not reflect the additional corporate stock or decedent's note; (v) the corporation's bookkeeper and accountant did not know about the agreement and note; and (v) the corporation did not demand payment of the note until after decedent's death.

The court did however hold that the $21,782 of accrued interest should not be included in decedent's estate under Code Secs. 2031 and 2033. Under Regs. §20.2031-4, the fair market value of accrued interest is the amount of the unpaid accrued interest as of the date of death, unless the estate establishes a lower value; in this case the value was zero because the corporation was insolvent and a willing buyer with knowledge of the corporation's financial situation would not pay any amount for the accrued interest.

Taxpayers' Transfers of Stock to FLPs Indirect Gifts of Stock to Children

In Senda v. Comm., 433 F.3d 1044 (8th Cir. 2006), husband and wife created two family limited partnerships, with the husband holding the general partnership interest in both partnerships. Each of husband, wife and their three children were designated as holding limited partnership interests with the children's partnership interests purportedly held for them in trust, although there was no written trust agreement at the time the partnerships were created and no tax returns were filed in the name of the trusts. The trusts were executed sometime after the creation of the second partnership. The children, as limited partners, reported income/losses from the first partnership on their individual tax returns.

Husband and wife transferred stock from their joint brokerage account to each of the partnerships at some time after each partnership's creation. The certificates of ownership reflecting transfers were not prepared and signed, as to the first partnership, until several years thereafter, and as to the second partnership, until several weeks after the transfers.

Husband and wife filed gift tax returns reflecting gifts of the partnership interests to the children with discounts for minority interest and lack of marketability. The Service issued a notice of deficiency, determining that the fair market value of the property transferred to the children was the value of the stock contributed to the partnerships without lack of marketability and minority interest discounts.

The Tax Court, citing *Shepherd v. Comr., 115 T.C. 376, 389 (2000), aff'd, 283 F.3d 1258 (11th Cir. 2002) and Jones Est. v. Comr., 116 T.C. 121 (2001)*, concluded that the transfers of stock to the partnerships, coupled with transfers of limited partnership interests to their children, constituted indirect gifts of stock to the children; and that the gift tax should be determined on the fair market value of the stock.

The Eighth Circuit agreed with the Tax Court's finding that the transactions were integrated steps in a single transaction. The court rejected taxpayer's claim that the Tax Court ignored state law that an entity cannot be disregarded because of deficiencies in documentation or the timing of certain transactions, stating that the Tax Court recognized the existence of the partnerships and the transactions under state law but then applied federal law in determining their tax treatment.

Estate Taxes Apportioned to Both Probate and Nonprobate Assets

In *Patrick v. Patrick, No. 03-04-00375-CV (Tex. Ct. App. 12/23/05)*, decedent died in 1999 with a Will that gave one-half of her probate estate to her son and divided the remainder equally among her daughter and daughter's four children. Several IRAs owned by decedent were distributed in equal shares to son and daughter.

Decedent's Will specified that all taxes payable because of her death should be charged against and paid out of her estate and that no contribution should be made by any insurance policy beneficiaries for any taxes on the policy proceeds. As executor, son paid over $3.2 million in estate taxes from the assets passing under decedent's Will. In a probate court accounting, the court held that decedent's estate taxes

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should have been allocated among all of decedent's assets, including the IRAs. Daughter filed an appeal to the probate court's decision, contending that the estate taxes should not be apportioned to the nonprobate assets because decedent's Will included instructions to the contrary.

The Texas Court of Appeals affirmed the probate court's holding that decedent's estate taxes should be apportioned among the probate and nonprobate assets. The court, explaining that the general rule under Texas law is that death taxes are apportioned among both probate and nonprobate assets unless there is a contrary direction in the will, stated that testamentary intent is the critical inquiry in construing a Will. The court found that the language in the Will requiring all taxes to be paid out of the estate was general in nature and was not a specific direction for apportionment different from Texas's general rule. Noting that the Will only provided an exception for insurance policies, with no mention of IRAs or other nonprobate assets, the court concluded that the estate taxes should be apportioned among all of decedent's assets.

Estate Tax Decision Not Determinative For Purposes of Mitigation Provisions

In *Malm v. U.S., No. A2-05-48 (D.N.D. 11/30/05),* decedent died in 1998. His estate included certain shares of stock, the value of which the Service had disputed and in July 2003, a district court ruled that the Service's stock valuation was correct. As a result of this ruling, the disputed stock had a higher fair market value than originally reported by the estate on its estate tax return. When the estate sold the stock, it used the erroneous valuation, thereby overstating the amount of gain on its income tax return filed on November 19, 1999. The estate filed a refund claim for income taxes paid on the sale on February 12, 2004 which the Service denied, stating that the claim was barred by the statute of limitations. While acknowledging that the three-year statute of limitations under Code Sec. 6511(a) for refunds had lapsed, the estate sought to invoke the mitigation provisions of Code Secs. 1311-1314 to obtain a refund.

The district court held that the estate was not entitled to invoke the mitigation provisions of Code Secs. 1311-1314 to avoid the statute of limitations because the estate tax decision handed down by the District Court establishing the value of the stock did not constitute a determination under Code Sec. 1313(a), and the basis-determination event was not the transaction in respect of which the erroneous recognition of gain occurred pursuant to Code Sec. 1312(7).

With respect to the first requirement, the court noted that a determination pursuant to Code Sec. 1313(a) includes "a decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final." The court cited two cases, *Evans Trust Co. v. U.S., 462 F.2d 521 (Ct. Cl. 1972), and Provident Nat'l Bank v. U.S., 507 F. Supp. 1197 (E.D. Pa. 1981)*, for the proposition that for purposes of the mitigation provisions, the determination can only be an income tax determination. The court noted that the Fourth Circuit in *Chertkof v. U.S., 676 F.2d 984 (4th Cir. 1982)* disagreed and held that an estate tax decision could qualify as a determination under Code Sec. 1313(a) but declined to follow this rationale because the legislative history and the Treasury regulations contradict the conclusion that an estate tax determination qualifies under Code Sec. 1313(a).

With respect to the second requirement under Code Sec. 1311 that a determination must be a specified circumstance of adjustment listed in Code Sec. 1312, the court stated that a party who asserts the circumstance of adjustment under Code Sec. 1312(7) must establish, among other things, that there exists a "transaction on which the basis of property depends." In this case, the sale of the stock is not the transaction that determined the basis of this stock but rather, the basis-determining transaction was decedent's death and, therefore, the sale of the stock cannot be characterized as a transaction that "in respect of which" there occurred a "described error."

Equitable Recoupment Allowed to Service in Estate's Refund Claim

In *Buder Est. v. U.S., No. 05-2145 (CA8 2/7/06)*, husband's Will created a residuary trust for the benefit of his wife and children. His estate made an improper election to treat the residuary trust as qualified terminable interest property and claimed a marital deduction for the trust's value. During litigation over a charitable deduction, the Service raised an affirmative set—off defense that the residuary trust did not qualify as QTIP, but the court refused to consider the defense because it was not raised timely.

When the wife died, the residuary trust was included on her estate's federal estate tax return and then later, the estate filed a claim for refund of federal estate tax based on incorrect inclusion of the trust on the return. The Service conceded that the estate was entitled to a refund plus

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interest, but argued that the amount of the refund should be offset by a proportionate amount of the tax that should have been paid on the trust by the husband's estate. Because the statute of limitations had run on any action by the Service to recover the tax, the Service invoked the doctrine of equitable recoupment.

On the basis of these facts, the district court held that (i) the elements of equitable recoupment were satisfied but limited the amount recouped by the Service to the tax burden that would have been borne if the improper QTIP election had not been made in husband's estate and the tax had been imposed in a timely manner, and (ii) the Service was not entitled to interest on the equitable recoupment.

The Eighth Circuit affirmed the decision, holding that the district court did not abuse its discretion in (i) applying the doctrine of equitable recoupment and (ii) denying the Service interest on the equitable recoupment.

Transferred Residence Includible in Decedent's Estate

In *Disbrow Est. v. Comr., T.C. Memo 2006-34 (2/28/06)*, decedent died in 2000 at the age of 78, leaving her estate, which consisted primarily of cash, stocks, bonds, and annuities, to her five children in equal shares. In 1993, when she was 72, decedent (together with her children and their spouses) formed a general partnership with decedent having a 28% interest in the partnership and the balance divided among her children and their spouses. No initial contributions were made to the partnership. Decedent then transferred her entire interest in the residence to the partnership for no consideration at which time she was assured that she could continue to live in the residence as long as she furnished the funds necessary to maintain it. In January 1994, she gifted her 28% interest in the partnership to her children and their spouses.

Although the partnership agreement stated that the partnership was "created to establish and conduct the business of real estate ownership and management," the partnership conducted no business and was not operated with an intent to make a profit. A lawyer, who had recommended the formation of the partnership to decedent for the stated purpose of keeping the residence out of her estate, prepared annual lease agreements under which the partnership rented the residence to decedent for each year from January 1, 1994, through December 31, 2000. The rental amounts stated in the leases were all significantly below the residence's fair rental value.

Decedent did not regularly pay her rent, she did not always pay the amount of rent that was stated in the lease agreements, and she often paid her rent later than the time required by the lease agreements; however the partnership never mailed decedent a notice demanding that she pay her rent or a notice of eviction. Decedent had the exclusive use and enjoyment of the residence. At her death, the fair market value of the residence was $400,000 but nine months later the partnership sold the residence to one of her sons for $350,000.

On the basis of these facts, the Tax Court held that the fair market value of the residence was includible in decedent's gross estate because decedent, until her death, retained the "possession" and "enjoyment" of the residence within the meaning of Code Sec. 2036(a)(1). Citing *Reichardt Est. v. Comr., 114 T.C. 144 (2000), and Rapelje Est. v. Comr., 73 T.C. 82 (1979)*, the Tax Court stated that there was an implied understanding and agreement between decedent and the partnership that she continue possession and enjoyment of the residence following its transfer to the partnership. Noting that decedent paid less than fair rental value for the exclusive possession and enjoyment of the residence, the court concluded that the annual lease agreements were a subterfuge to disguise the testamentary nature of the transfer. In addition, noting that decedent transferred the residence to the partnership on the advice of counsel to minimize estate taxes, the court further concluded that the partnership was not a business operated for profit, but a testamentary device.

Fourth Circuit Vacates Ruling of No Insurable Interest In Decedent's Life

In *Chawla v. Transamerica Occidental Life Insurance, No. 05-1160 (4th Cir. 3/7/06)*, decedent was seventy-two years old in 2000 when an initial life insurance application on his life was made. In October 1999, decedent had brain surgery to remove a tumor. In November 1999, serial taps were performed to drain a fluid that had collected in his brain following surgery. Decedent continued to experience problems with fluid collecting in his brain and, in December 1999, physicians inserted a shunt in an attempt to drain the excess fluid. The physicians' records from that period also indicate a diagnosis of chronic alcohol abuse and, on February 1, 2000, decedent was admitted to the hospital for alcohol abuse.

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In May 2000, a friend of decedent's, who had accompanied him to medical appointments throughout this period, applied for a life insurance policy with coverage in the sum of $1 million on decedent's life. The friend was to own and be the sole beneficiary of the policy.

Neither decedent nor his friend ever disclosed to the insurance company decedent's surgeries, his two hospitalizations in January and February 2000, or his alcohol problems answering in the negative to questions about hospital treatments, surgical procedures and treatment for alcohol abuse in the past five years.

The life insurance company rejected the initial life insurance application because it concluded that decedent's friend, the intended beneficiary, lacked an insurable interest in decedent's life. Shortly thereafter, a revised life insurance application was submitted, naming a 1995 trust, of which decedent and his friend were trustees and the friend the sole beneficiary, as the proposed owner and beneficiary of the policy. The insurance company approved the revised life insurance application and delivered the policy, with coverage in the sum of $1 million (later increased to $ 2.45 million).

Decedent died of heart failure in September 2001. In July 2002, after conducting an extensive investigation, the life insurance company rescinded the policy on the ground that decedent had failed to make full disclosure in completing the application.

On the basis of these facts, the district court, in *Chawla v. Transamerica Occidental Life Ins., F. Supp 2d, Civil Action No. 03-CV-1215 (ED VA, Feb. 3, 2005),* granted summary judgment to the insurance company concluding that (i) material misrepresentations made on the life insurance applications entitled the insurance company to rescind the policy; and (ii) the trust lacked any insurable interest in decedent's life.

The Fourth Circuit affirmed the summary judgment award on the basis of misrepresentations in the life insurance applications. The Fourth Circuit then vacated as unnecessary the district court's alternative ruling that the trust lacked an insurable interest in decedent's life, noting that the district court's alternative ruling appears to have unnecessarily addressed an important and novel question of Maryland law and further noting that this important aspect of the doctrine of judicial restraint has particular application when a federal court is seemingly faced with a state-law issue of first impression.

II. IRS REVENUE RULINGS, REVENUE PROCEDURES AND NOTICES

The Service Extends Rev. Proc. 2005-24 For CRTs

In *Notice 2006-15, 2006-8 I.R.B. 501, 02/03/2006,* the Service has extended Rev. Proc. 2005-24's June 28, 2005 grandfather date for charitable remainder trusts subject to spousal elective share rights until further guidance is issued.

Rev. Proc. 2005-24, 2005-16 I.R.B. 909 applies to any charitable remainder trust if applicable state law gives the grantor's surviving spouse an elective share right, exercisable at the grantor's death, to receive a statutory share of the grantor's estate that could be satisfied in whole or in part from CRT assets, in violation of Code Sec. 664(d)(1)(B) or (2)(B). Rev. Proc. 2005-24 provides a safe harbor under which the Service will disregard the spouse's elective share right if the spouse irrevocably waives the right in the manner outlined in the revenue procedure. Rev. Proc. 2005-24 also states that the Service will disregard the elective share right, even without a waiver, for CRTs created before June 28, 2005, as long as the spouse does not exercise the right.

Indicating that commentators have suggested that Rev. Proc. 2005-24 puts an undue burden on taxpayers and trustees trying to comply with the safe harbor rule, the Service stated that it is considering alternative safe harbor rules and, thus, is extending the June 28, 2005 grandfather date. Until further guidance is published, the Service will disregard the existence of such a right, even without a waiver, but only if the spouse does not exercise the right.

III. IRS PRIVATE LETTER RULINGS AND TECHNICAL ADVICE MEMORANDA

No Inclusion in Grantors' or Beneficiaries' Estates

In *PLRs 200546052-055,* a family patriarch had five children, all of whom are now deceased. During their lifetimes, patriarch and his children created various irrevocable trusts, some created before September 25, 1985, and some created after that date, to benefit the descendants of patriarch's children. The trusts contain various provisions including in some instances, (i) the trustees (but not the grantors or beneficiaries) have uncontrolled discretion to distribute income and/or principal to trust beneficiaries, (ii) some beneficiaries

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have testamentary limited powers of appointment over their trusts, (iii) some beneficiaries have general powers of appointment over portions of the trusts, and (iv) various persons have the power to name successor trustees for the trusts.

The family, consisting of patriarch's descendants, have agreed to form a trust company as a wholly-owned subsidiary of a corporation which will serve as an independent trustee of all of the trusts. The corporation's shareholders are individual members of the family, trusts related to members of the family, and foundations having a relationship with the family.

The trust company's bylaws provide for a board of directors of at least 5 but no more than 25 persons. The trust company must have at least one director who is not a member of the family or a grantor of, donor to, or beneficiary of any of the trusts. All discretionary decisions regarding the trusts must be made by trust officers who are neither members of the family nor the spouse of a family member. A trust beneficiary can request that the trust company's senior trust officer review the discretionary decisions of other trust officers. The board may also designate a discretionary decisions review committee, which will include at least three board members and which has the power to review discretionary decisions made by the trust company's officers upon the written request of a trust beneficiary and make a final decision.

On the basis of these facts, the Service ruled that (i) the trust company is not a Code Sec. 672(c) related or subordinate party as to the affected trusts; (ii) the trust company may exercise the powers described in Code Sec. 674(c) without causing the trust grantors to be treated as the owners of any portion of the trusts under Code Sec. 674(a); (iii) although the terms of the trusts and the trust company's bylaws do not reveal any circumstances that would cause Code Sec. 675(4) to apply, the factual determination of whether any trust grantor will be treated as the owner of any portion of a trust under Code Sec. 675(4) must be deferred until the Service examines the parties' tax returns; (iv) no living trust grantor's ownership in the trust company or service on its board or committees will give the grantor an interest or power that would cause the grantor to be treated as the owner of any portion of the trusts under Code Sec. 677; and (v) no trust beneficiary's ownership interest in the trust company or service on its board or committees will cause the beneficiary to have the power exercisable solely by that beneficiary to vest trust corpus or income in himself or herself under Code Sec. 678(a); (vi) the appointment of the trust company as a trustee of the trusts will not cause inclusion of the trusts in a grantor's or beneficiary's estate under Code Sec. 2036, Code Sec. 2038, or Code Sec. 2041; and (vii) the trust company's appointment as a trustee of trusts created before September 25, 1985 will be an administrative change for GST tax purposes and will not be considered a shift in beneficial interests under Regs. §26.2601-1(b)(4)(i)(D)(1).

The Service based its estate tax rulings on the fact that the firewall provisions in the trust company's bylaws and the trustee provisions in the trust instruments (i) sufficiently prohibit trust grantors and beneficiaries from participating in and reviewing discretionary distributions from their trusts and prevent outside reciprocal agreements that might give the family members indirect control over their trusts for purposes of Code Secs. 2036 and 2038, and (ii) preclude the trust beneficiaries from having the power to affect the beneficial enjoyment of the trust property as contemplated by Code Sec. 2041.

Substantial Compliance For Timely Allocation Of GST Exemption

In *PLR 200550006,* during his life, decedent created an irrevocable GST trust. Decedent also created a revocable trust and then he and the revocable trust created a limited partnership, with decedent owning the general partnership interests and the revocable trust owning the limited partnership interests. Subsequently, as trustee of the revocable trust, decedent assigned a portion of the limited partnership interests to the irrevocable trust. Decedent hired an accounting firm to prepare a gift tax return to report this transfer to the irrevocable trust. The return properly identified the transferred property and indicated that decedent was allocating GST exemption equal to the value of the interests transferred. However, despite decedent's intention to allocate GST exemption to the irrevocable trust, the return inadvertently misidentified the donee of the gift. Decedent's estate requested a ruling that the gift tax return had substantially complied with the Code Sec. 2632 and Reg. §26.2632-1(b) requirements for timely allocation of GST exemption to the irrevocable trust such that the trust has a zero inclusion ratio.

On the basis of these facts and citing Rev. Rul. 61-128, 1961-2 C.B. 150, the Service ruled that the information contained on decedent's gift tax return was sufficient to constitute a timely allocation of the

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specified amount of GST exemption to the irrevocable trust despite decedent's failure to comply with the gift tax return instructions and his misidentification of the actual donee.

Special Actuarial Factor Used to Value Gifts

In *PLR 20055101,* taxpayer, who owned life estates in 20 parcels of real estate, conveyed his life estates to the remainderman of each property, thereby creating fee simple interests in each of the remaindermen. At this time, taxpayer had been diagnosed with metatastic cancer and his health was declining. He died 57 days later.

Taxpayer's estate sought a ruling for a special factor to be used in valuing taxpayer's gifts to the remaindermen. Noting that, under Regs. §25.7520-3(b)(3), a gift measured by the life of an individual who is terminally ill is valued using a special factor, rather than the Code Sec. 7520 valuation tables, and concluding that taxpayer was terminally ill within the meaning of Regs. §25.7520-3(b)(3) on the date of the conveyances and that therefore the valuation tables did not apply to his gifts, the Service ruled that a special actuarial factor of .03325 must be used in valuing the gifts.

Recognition of Gain or Loss and Basis of New Trusts Determined Following Merger and Division

In *PLR 200552009*, a parent established four family trusts for the benefit of his grandchildren and their issue with each family trust having identical provisions and beneficiaries and the same trustee. Each family trust owns a 99% general partnership interest in a general partnership and the parent's child (the parent of the grandchildren) owns the remaining 1% general partnership interest in each of the general partnerships.

The trustees proposed to merge the four trusts and then divide them pro rata into four separate new trusts, one for each grandchild's family, taking into account the separate investment objectives of the grandchildren and their families. Each new trust would have substantially the same terms and hold equal interests in all four partnerships.

The Service ruled on the basis of these facts that where new trusts have substantially same terms and hold same interests as original family trusts after merger of such family trusts and redivision of merged trusts, no gain or loss is recognized, and the original family trusts' bases, holding periods, and tax attributes carry over without limitation.

With respect to whether gain or loss would be recognized on the trust merger and division, the Service stated that the interests of the new trusts' beneficiaries would not differ materially from their interests in the respective family trusts before the merger and division. Each beneficiary would continue to hold, through the beneficiary's interest in a new trust, the same beneficial interest in each asset of the four family trusts that he or she held before the merger and division, and each interest in the divided trust would contain substantially the same terms.

With respect to the merged trust's basis and the new family trusts' basis in the assets of the merging family trusts, citing Code Sec. 1015(b) and Regs. §1.1015-2(a)(1), the Service concluded that, because Code Sec. 1001 would not apply to the proposed mergers, the merged trust's basis immediately after the mergers would be the same as the merging family trusts' basis immediately before the mergers. In addition, because Code Sec. 1001 would not apply to the proposed division of the merged trust, under Code Sec. 1015, the new trusts' tax basis in the assets of the new trusts immediately after the division would be the same as the tax basis of the merged trust in the assets immediately before the division.

Donor's tuition prepayments under written agreements will qualify for gift tax exclusions

In *PLR 200602002*, donor's six grandchildren currently attend a Code Sec. 170(b)(1)(A)(ii) school. Donor plans to enter into a separate written prepaid tuition arrangement with the school for each grandchild for multiple years, under which donor agrees to prepay the grandchild's total annual tuition through grade 12, based on the school's current tuition rates. Each agreement states that tuition may increase in subsequent years and that the balance due for a particular year, after application of donor's prepayment for that year, will be paid by donor or the respective grandchild's parents, who will sign a consent and joinder. The agreement further states that the tuition prepayments are nonrefundable.

The Service ruled on the basis of these facts that donor's tuition prepayments to the school will constitute qualified transfers excluded from gift tax under Code Sec. 2503(e)(2)(A) as payments made directly to an educational organization exclusively for the specific tuition costs for designated individuals. In addition, under Code Sec. 2611(b)(1), which provides that transfers not treated as gifts pursuant

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to Code Sec. 2503(e) are not treated as generation-skipping transfers, the Service also ruled that the tuition prepayments will not constitute generation-skipping transfers.

Funds Transferred to CRUT in Error Can Be Restored to Grantor Without Disqualifying Trust or Resulting in Self-Dealing

In PLR 200601003, donor created a charitable remainder unitrust of which she and her husband are income beneficiaries, naming her personal financial advisor as trustee.

Donor, who had invested a portion of her personal funds in warrants, instructed the advisor to prepare a redemption notice, to liquidate the warrants and transfer the proceeds to her personal money market account. However, the redemption notice listed the CRUT account and consequently, the warrant proceeds were wired to the CRUT account and placed in a separate fund within that account. At all times since the transfer, the proceeds have been segregated.

After donor asked her attorney to review the CRUT administration, attorney discovered that the warrant proceeds had been deposited into the CRUT's account. Donor had never intended to donate the proceeds to the CRUT, and had not taken a charitable deduction for the transfer. However, the advisor/trustee had included the value of the proceeds in calculating the unitrust distributions to donor and her husband for three years.

Subject to donor obtaining a favorable private letter ruling, a court ordered that because donor had not made a valid donation to the CRUT, the trustee must restore the warrant proceeds (reduced by the unitrust distributions that were attributable to the proceeds as of the date of the court order or thereafter and increased by the earnings attributable to the proceeds as of the date of the court order) to donor.

The Service ruled, on the basis of these facts, that the warrant proceeds will be deemed to have never been part of the CRUT's principal at any time for federal tax purposes. The restoration of the warrant proceeds, as directed by the court order, will not disqualify the CRUT under Code Sec. 664(d)(2) or constitute an act of self-dealing under Code Sec. 941(d)(1)(E) as to donor or a payment to a disqualified person under Code Sec. 4946. The rulings are conditioned on: (i) donor, her husband and the CRUT amending their income tax returns for the affected years; (ii) donor and her husband reporting any interest generated by the investment of the warrant proceeds; (iii) trustee reducing the amount of the restoration by any unitrust distributions after the date of the court order and before the restoration; and (iv) trustee increasing the amount of the restoration by any earnings attributable to the proceeds after the date of the court order and before the restoration.

Insurance Policy Transferred to Trust Deemed a Gift

In *PLR 200603002*, husband and wife each owned a life insurance policy with a net interpolated terminal reserve value. They each transferred their respective policies to a revocable trust created by their four children. Under the terms of the trust, each child may revoke his or her participation in the trust at any time and withdraw his or her share of the trust's assets.

The documents transferring the policies each provided that the transfers were subject to a deferred obligation from the trust to husband and wife, represented by a note in the amount of the combined cash values in the policies, less the amount husband and wife expected would be excluded as taxable gifts under Code Sec. 2503(b) for the year of the transfer.

The transfer document stated that (i) husband and wife planned to exchange both transferred policies for a single joint and survivor policy that would be owned by the trust in lieu of the two transferred policies; and (ii) each trust beneficiary acknowledged the gifts to the trust and stated that he or she would contribute funds to the trust to satisfy the note to husband and wife and to pay the premiums on the new policy. No gift tax returns were filed for the transfer year. the trust never made any payments on the note and in a later year, husband and wife signed an instrument forgiving the trust's note.

Shortly after executing the transfer instrument, husband and wife directed their insurance agent to exchange the transferred policies for a single joint and survivor policy which was to be titled in the trust's name. Although the policies were exchanged for a new joint and survivor policy, the new policy lists husband and wife as owners. The insurance company has sent the premium notices on the new policy to the trust and the trust has paid all premiums on this policy. Husband and wife plan to reform the new policy ownership to clarify that the trust owns the new policy by assigning the policy to the trust.

Although the parties did not request a ruling on the gift tax consequences of these transfers, the

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Service ruled that husband and wife's transfers of their respective single life policies to the trust, subject to the trust's deferred note, and their subsequent forgiveness of the note were part of a prearranged plan to avoid owing gift tax on the transfers. The facts supported a finding that because husband and wife intended to forgive the note at the time of the transfer, the note was not adequate and full consideration for the transfer and husband and wife had gifted the amount of the note.

The Service also ruled that the reformation or assignment of the new policy to reflect the trust as owner will not be a transfer subject to gift tax under Code Sec. 2512 and will not cause the new policy proceeds to be included in either husband's or wife's gross estate under Code Sec. 2035 if husband or wife dies within three years of the reformation or assignment.

Citing *U.S. v. Rhode Island Hospital Co., 355 F.2d 7 (1st Cir. 1966),* the Service noted that the insurance policy provisions generally govern the relationships between the insured, the insurer, the owner, and the beneficiary. Evidence that the policy provisions do not conform to the parties' intent must overcome a heavy presumption in favor of the document. An exception will be recognized when the insurance contract does not reflect the parties' instructions. In this case, husband's and wife's intent on the ownership of the new policy was reflected in contemporaneous instruments (the transfer document and the trust's governing agreement) and the fact that the insurance agent failed to follow their instructions.

Gift To Husband Will Qualify For Marital Deduction

In *PLR 200604028,* husband and wife each created a revocable trust. Wife plans to amend her trust to provide that: (i) during her lifetime, she will receive trust income and principal as she requests; (ii) the trustee may distribute trust income and principal to or for her and her husband's benefit to maintain their accustomed manner of living; (iii) upon wife's death, the trustee will distribute the trust assets to husband outright; (iv) husband will have the right to disclaim the trust assets he would receive at wife's death and have them held by a credit shelter trust for his benefit; (v) if husband does not survive wife, the remaining assets would pass to a trust for husband and wife's children at wife's death; and (vi) if wife is living at husband's death, husband will have a testamentary general power of appointment over the trust assets equal to his remaining Code Sec. 2010 estate tax applicable exclusion amount less the value of husband's taxable estate (determined by excluding the trust assets subject to his power).

Husband plans to amend his trust to state the same provisions as will be contained in wife's trust with the exception that wife will not have a testamentary power of appointment under his trust if she predeceases him. Husband also plans to sign a new Will that will exercise his testamentary general power of appointment under wife's trust, appointing assets from her trust to his trust equal to his remaining exclusion amount less the value of his taxable estate.

The Service ruled on the basis of these facts that (i) if husband predeceases wife, the value of the her trust assets subject to husband's testamentary general power of appointment will be included in husband's gross estate; (ii) if husband predeceases wife and exercises the power, wife will be treated as relinquishing her dominion and control over the property subject to the power and wife will make a Code Sec. 2501 completed gift to husband that will qualify for the Code Sec. 2523 gift tax marital deduction; (iii) any assets that originated in wife's trust and that are distributed to or from husband's trust will not be gifts from wife to the other beneficiaries of husband's trust; and (iv) if husband predeceases wife and exercises his power of appointment over her trust assets, any assets in husband's trust that wife disclaims (which will be held in a credit shelter trust for her benefit) that originated in her trust and passed to his trust by virtue of husband's exercise of his power will not be included in wife's gross estate.

Trust Principal Will not be Included in Grantor's Estate

In *PLR 200606006*, a grantor created an irrevocable trust, funding it with cash and marketable securities and appointing a trustee who is not as to the grantor a Code Sec. 672(c) related or subordinate party. The trust provides that income and principal may be distributed to grantor's spouse for any reason not prohibited by the trust terms. After grantor's death, the trust is also to distribute the principal to wife for her health, maintenance, and support. Wife has an inter vivos power to appoint the trust assets to grantor's issue but the trust may not make a distribution that would fulfill wife's obligation of support. Wife also has a testamentary limited power of appointment over the trust. To the extent she does not exercise this power at her death, the trust is to distribute the remaining the trust assets to grantor's issue. Upon any contribution to the trust, wife has a

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right of withdrawal limited by the trust terms.

The trustee has sole and absolute discretion to invest, dispose of, and deal with the trust assets without anyone's approval or consent. The grantor has the power, exercisable only in a fiduciary capacity, to acquire the trust assets by substituting assets of equal value. Under the trust terms, an action is in a fiduciary capacity if the action is undertaken in good faith, is in the trust's and the beneficiaries' best interests, and is subject to state law fiduciary standards.

Grantor plans to exercise his substitution power by transferring shares of one publicly traded company to the trust in exchange for the trust's shares in another publicly traded company. If necessary to equalize the value of the shares exchanged, the grantor will either add to or withdraw from the trust other cash or cash equivalents, determining the value of each company's shares in accordance with Regs. §25.2512-2(b)(1).

On the basis of these facts, the Service ruled that (i) grantor's retained power of substitution over the trust assets will not cause the trust assets to be included in grantor's estate under Code Sec. 2033, Code Sec. 2036(a)-(b), Code Sec. 2038, or Code Sec. 2039, (ii) grantor's proposed exercise of the power of substitution, as described above, will not be a gift to the trust by the grantor for federal gift tax purposes, (ii) grantor is treated as the owner of the trust under Code Sec. 677 and, thus, the trust is a grantor trust in its entirety as to the grantor, notwithstanding wife's withdrawal powers that would otherwise make wife the owner of a portion of the trust under Code Sec. 678, and (iv) because the grantor is the owner of the trust in its entirety, neither the grantor nor the trust will recognize income or loss under Code Sec. 61 or Code Sec. 1001 if the grantor exercises his substitution power.

Exchange of Life Insurance Policies Disregarded

In *PLR 200606027,* taxpayer created a trust for the benefit of his children which owns a single life insurance policy on his life and a survivorship policy on his life and the life of his deceased wife. Taxpayer also created a second trust for the benefit of his grandchildren which also owns a single life insurance policy on his life and a survivorship policy on his life and the life of his deceased wife. Both trusts are grantor trusts under Code Sec. 671.

The trustee of the children's trust proposes to transfer the policies in that trust to the trustee of the grandchildren's trust in exchange for the polices in the grandchildren's trust. The policies to be exchanged will be valued using their interpolated terminal reserve values (including any unused premiums) as provided in Regs. §25.2512-6(a). The trustees anticipate that the combined interpolated terminal reserve values of the policies in the children's trust will be greater than the combined interpolated terminal reserve values of the policies in the grandchildren's trust. The grandchildren's trust will either transfer additional assets to the children's trust or issue a promissory note bearing interest at the applicable federal rate equal to any deficiency.

On the basis of these facts, the Service ruled that: (i) the transfer of the policies from each trust to the other trust with the added consideration will be disregarded for federal income tax purposes and will not result in recognition of gain or loss under Code Sec. 1001; and (ii) the "transfer-for-value" rule of Code Sec. 101(a)(2) will not apply to diminish the exclusion from gross income under Code Sec.101(a)(1) for amounts received by the beneficiaries of each of the four policies.

Citing *Rev. Rul. 85-153, 1985-1 C.B. 184,* the Service noted that a transaction cannot be recognized as a sale or exchange if the same person, such as a grantor, is treated as owning the purported consideration both before and after the transaction. Because the grantor would own the consideration in the trusts both before and after the transaction, the transaction will not result in the recognition of any gain or loss under Code Sec. 1001. Because the exchange is disregarded for federal income tax purposes, there is no "transfer for valuable consideration" within the meaning of Code Sec. 101(a)(2) and Regs. §1.101-1(b)(4).